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TAX - Q3 2016 Liberty Tax Inc Earnings Call

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PRESENTATION

Operator

Good morning. My name is Darla and I will be your conference operator today. At this time I would like to welcome everyone to the Liberty Tax, Inc., third-quarter fiscal-year 2016 earnings conference call. (Operator Instructions)

Thank you. I would now like to turn the conference over to Vanessa Szajnoga. Please go ahead.

Vanessa Szajnoga - Liberty Tax, Inc. - VP Legal

Thank you, Darla. Good morning, everyone, and thank you for joining us. With me today are John Hewitt, our founder, Chairman, and Chief Executive Officer, and Kathy Donovan, our Vice President and Chief Financial Officer.

The press release announcing our third-quarter earnings was distributed this morning. The earnings release may be accessed at the Investor Relations section of our website located at the www.LibertyTax.com.

A replay of this call will be available shortly after its conclusion. The information to access the replay was in the earnings press release.

I'd like to remind everyone that today's remarks may include forward-looking statements as defined under the Securities Exchange Act of 1934. Such statements are based on current information and management's expectations as of this date, and are not guarantees of future performance. Forward-looking statements involve certain risks, uncertainties, and assumptions that are difficult to predict. As a result, our actual outcomes and results can differ materially.

You can learn more about these risks in our annual report on Form 10-K for the fiscal year ended April 30, 2015, and our other SEC filings. Liberty Tax undertakes no obligation to publicly update these risk factors or forward-looking statements.

I would now like to turn the call over to our founder, Chairman, and CEO, John Hewitt. John?

John Hewitt - Liberty Tax, Inc. - Chairman, President, CEO

Thank you, Vanessa, and good morning, everyone. Thank you for joining us today.

There are three certainties in life: death, taxes, and change. So far, through the early part of this tax season, change has certainly played a role.



Taxpayers are again delaying the filing of their taxes, continuing a multiyear trend. With that said, we appreciate this opportunity to provide you with more insight into our results to date and to tell you more about our expectations for the industry and the Company going forward.

This tax season we increased the number of permanent offices by nearly 200. However, due to the decrease in number of seasonal locations the overall combined office count grew by a net of 156.

Although this growth is lower than we would like, we are pleased that the growth was driven by permanent locations. While we are focused on growing in each category, placing an emphasis on increasing our permanent offices will have a larger impact on future return growth.

New territory sales obviously play a large part in expanding office count. As of the end of January we have sold 180 total US and Canadian territories, compared to 160 at the same point last year.

Of these sales, 112 were sold to new franchisees, compared to 113 at the same point last year. To reach our ultimate goal of about 11,000 locations in the US, our target is to average six to seven offices per franchisee.

Because each of our competitors have peaked at over seven offices per franchisee, our current population of over 1,800 franchisees should be able to get us to our target. We have already begun selling territories for next season to new prospects and existing franchisees who missed the opportunity to join the team this year. In addition, we have reorganized our sales team to place more focused on assisting existing franchisees to expand.

Our Company store program has grown to the largest in Company history. We are currently operating over 250 US Company stores compared to just 125 last year.

This includes our new cluster program, where we selected major metropolitan areas, such as Dallas, Miami, and Seattle, in which to open clusters of five to seven offices per market. Currently, we are operating about 80 cluster offices that can provide prospective and existing franchisees with an opportunity to grow by purchasing these turnkey-ready offices. We plan to continue this program, and many areas developers have already expressed interest in working with us to expand the program into their areas next season.

Our SiempreTax+ brand has grown by over 150% compared to last season. We now have 144 active locations.

We will continue to set aggressive goals for our SiempreTax+ division. The increasing importance of the Hispanic community in the US makes this an ideal time to expand the SiempreTax+ brand and establish a strong foothold in the community.

With that said, let's give you some updated numbers through February 28th. Our systemwide revenue has grown by 0.8%. This reflects an increased average net fee of 4.7%, partially offset by a decline in overall returns of 4%.

While these numbers do not meet our own expectations for return count growth, the tax professional industry as a whole is down 3.6% through February 26th. We estimate that 2 million to 3 million returns that would have regularly been filed by this time will be pushed out into the second half of the season.

We continue to believe that the Affordable Care Act will drive more people to paid preparers, but are also now expecting to see all of that impact later in the season. Many 1095s, or employer-provided health insurance forms, may not be mailed out until late March, which may be causing some taxpayers to delay filing their returns.

Furthermore, the penalty has increased over 200% this tax season. And we believe this will help to drive more people to elect for filing through a paid tax preparer later this tax season.

As a result of these impacts, less than half of the individuals have filed their tax returns so far this year. We are expecting a late-season tailwind that will provide us plenty of opportunity to execute on our system and gain market share.

Lastly, I would like to address a challenge that continues to face the entire tax industry: Fraud. Prevention of fraud remains a fundamental goal of our Company, and so we take seriously recent news concerning potentially inappropriate activity in a small number of franchised offices.

We make clear to our franchisees that there is no place in the Liberty Tax system for franchisees or preparers employed by them, who commit fraud or take other shortcuts. We understand that even though these claims involve an extremely small number of our franchise owners and their offices, any inappropriate behavior affects our brand and the integrity of the tax system.

We are cooperating in every possible way with the authorities that have raised these issues and have been proactive in taking steps to address their concerns, including preventing some preparers from filing returns in our system, blocking some franchisees from filing certain types of returns, and terminating some franchisees. We have committed significant efforts over the last year to bolster our compliance program.

In addition to internal improvements that have been enabled us to use both data analyze and on-the-ground reviews to combat fraud, we've been active since last year in working with the IRS, state agencies, and the rest of the industry to address the growing concern over identity theft tax fraud both online and in offices. We're also working with outside legal advisors and tax experts in a process that has been ongoing for some time to evaluate our compliance processes and make recommendations about further improvements.

For the short term, these fraud concerns will impact return counts this year, and we estimate a low to mid single-digit impact negative. In a system that includes thousands of offices and 35,000 tax preparers hired by our franchisees, it unfortunately is inevitable that some franchisees or preparers or their customers will engage in behaviors that Liberty doesn't condone and will not tolerate. However, we're addressing the risk in a systematic way with steps that we believe are appropriate and effective, and our work in this area should position us to be a stronger Company going forward.

Despite early-season results, we believe this is a great time to be in the tax industry. We remain committed to identifying new and existing growth opportunities, and we will continue adapting to this dynamic industry.

I am looking forward to taking your questions after Kathy walks through the financials. Now I'd like to turn the call over to our CFO, Kathy Donovan, to take you through the details of our third-quarter results.

Kathy Donovan - *Liberty Tax, Inc. - CFO*

Thanks, John. Good morning, everyone. As we turn our focus to the third quarter, I'm going to start with an overview of revenue.

Our total revenue grew 12.5% to \$53.6 million. A large portion of the increase was driven by financial products. Despite a 3.9% reduction in return count, our financial products group had a strong quarter.

Financial products increased 29% to \$17.3 million. Our new Refund Advance product drove much of the revenue increase, but we also benefited from increased pricing, improved attachment rates, and our decision to process 100% of our financial products in-house this year compared to 73% last year.

As expected, tax preparation fees were also up this year, reflecting the higher number of Company stores, driven by our new cluster program. As John said, we are pleased with the Company store cluster initiative and expect this new program to help us drive store count growth going forward.

To finish up on revenue, our royalty and advertising fees were flat to prior year. A 4.5% increase in average net fee was offset by the lower early-season volumes.

Switching to expenses, the increase in operating expense was primarily due to the costs associated with our new Refund Advance product along with the higher salaries and administrative costs related to the increased number of Company-owned stores.

We also increased advertising expense in the quarter. This is primarily due to timing; and on a year-to-date basis our advertising expense is flat to the prior year.

Going forward, we have made some recent adjustments to better align our cost structure with the changes we have seen in the market. We have cut costs in several areas, including seasonal support staff and overhead, as well as reductions in the level of investment around the Affordable Care Act now that that market has stabilized.

One other item to note when comparing results to prior year. During the third quarter of 2015, our SG&A expenses included a \$4.1 million estimate for the probable loss on a class action lawsuit. We have removed that cost from the prior-year results in our adjusted earnings on schedule E of the press release.

Turning to taxes, during the third quarter Congress reapproved on a permanent basis the R&D tax credit for 2015. As a result, we recorded a cumulative adjustment to bring our year-to-date effective tax rate down to 37.5%.

Due to several factors including the seasonal nature of our business and the relatively smaller pretax income in Q3, as compared to the losses in the first half of the year, the year-to-date adjustment resulted in an effective tax rate for the third quarter of 42.6%. Because that credit has now been made permanent, our quarterly tax rate going forward should show less volatility throughout the year.

Finally, on a GAAP basis our EPS for the quarter was \$0.34 per share, compared to \$0.13 last year. And on an adjusted basis, excluding that litigation expense I just described which was incurred last year, our EPS improved from \$0.29 to \$0.34.

Now let's take a quick look at the balance sheet. Our revolver balance at the end of the quarter was \$150.7 million compared to \$110.8 million last year.

The higher borrowing reflects two major changes. First, an unexpected delay in IRS funding. Our first large federal funding was received on February 3 this year compared to January 30 last year. That caused a \$25 million shift in cash from Q3 to Q4.

Secondly, higher off-season lending to our franchisees, particularly during the first half of the year, also increased our usage of the line. As regularly happens at this time of year, we are rapidly repaying that balance and have already repaid close to \$100 million as of last night. As we continue to receive funding from the IRS, we expect to fully repay the revolver by the end of March and deliver strong free cash flow for the year.

In conclusion, we would like to reiterate our commitment to delivering value to our shareholders. To that end, our Board has approved our fifth consecutive quarterly dividend of \$0.16 per share, and we remain focused on making operational changes to improve efficiency and to help us drive consistent, profitable growth.

With that, John and I would now be happy to answer your questions. Darla?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Lee Jagoda, CJS Securities.

Lee Jagoda - *CJS Securities - Analyst*

Hi, good morning. John, I just missed the number earlier. Systemwide revenue through to 2/28 was up how much?

Kathy Donovan - *Liberty Tax, Inc. - CFO*

0.8%.



Lee Jagoda - *CJS Securities - Analyst*

0.8%? Okay. Then just switching gears to the financial products, how does the accounting for the Refund Advance product influence financial products revenue?

Kathy Donovan - *Liberty Tax, Inc. - CFO*

We are charging a fee to our franchisees for offering that product to the customer. There is no fee to the customer, and we record that income as revenue. We also then will have an offsetting cost that goes to our banks. As we've mentioned before, it's not a high-margin product for us, but the revenue is recorded on the revenue line and the cost is recorded in the SG&A line.

Lee Jagoda - *CJS Securities - Analyst*

Okay. Then the next question would be, in order to receive that product, does the customer have to use your Refund Advance product? And how does that affect attachment rates?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

No, the customer does not have to get a refund transfer in order to get the loan product. So it has little effect on our rate of attachment.

Lee Jagoda - *CJS Securities - Analyst*

I guess excluding that, then, how has attachment rate trended thus far through the season? What are the other factors impacting that financial products line so positively?

Kathy Donovan - *Liberty Tax, Inc. - CFO*

As I mentioned, there were several things, actually. We saw some favorable pricing in that area, where we have seen some increases in costs from our banks, but we know that our products have been priced very favorably to the industry for several years and we've not had a price increase in that area in at least three or four years. So we saw some increased pricing on our side offset by a little bit of increased expense. We did see slightly higher attachment rates. It's a combination of those things.

Lee Jagoda - *CJS Securities - Analyst*

Got it. Can you give us some color or sense into how much prices increased within the refund transfer product?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Well, it's complicated because it includes the advance. It's certainly in the ballpark of 10%.

Lee Jagoda - *CJS Securities - Analyst*

Okay. Then, John, you had mentioned that you would expect a low to mid single-digit negative impact from fraud prevention measures this tax season. Is that industrywide or for Liberty?

And given that impact, do you still expect to outperform the overall assisted industry?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

The impact of the single to mid digit includes both the loss of returns that were possible fraud or fraudulent and the negative press around that. It's difficult to say -- the industry doesn't share notes on how much or what percentage of their business is being impacted by fraud. Listening to our competitor's call last night, they tend to spend a significant time on their calls talking about fraud so I would say that if my judgment from afar is that they would have at least mid single-digit negatives, if not low to mid digit, the same as us.

Lee Jagoda - *CJS Securities - Analyst*

Again, despite that do you expect to outperform the overall assisted industry and gain share this tax season?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

We've always done that before, but we're not making any projections.

Lee Jagoda - *CJS Securities - Analyst*

Okay. I'll hop back in queue. Thanks.

Operator

Alex Paris, Barrington Research.

Alex Paris - *Barrington Research Associates, Inc. - Analyst*

Thank you. Same line of questioning on that fraud issue, just to get a little clarification or so I understand it a little bit more clearly. What's your expectation for total number of returns filed with the IRS this tax season, first of all?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

We think there's going to be an increase of somewhere in the 2 million more filers this year than last year.

Alex Paris - *Barrington Research Associates, Inc. - Analyst*

That's even including the impact from fraud?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Yes. Those people still have to file tax returns. Many of them may go online or they may go to the mom-and-pop preparers that are less diligent on committing fraud. But they are still going to file a return.



Alex Paris - *Barrington Research Associates, Inc. - Analyst*

The bad guys, you mean? The fraudulent guys?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Yes.

Alex Paris - *Barrington Research Associates, Inc. - Analyst*

Yes? Okay, so what did you mean about the -- maybe I'm dense, but what did you mean about the mid single-digit decline, the impact both from the loss of returns of those potentially fraudulent returns and other issues? What are we talking about? Can you just explain that to me again? I apologize.

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Sure. The fraud -- when you think of fraud, that comes from customers coming in trying to defraud us and trying to defraud the IRS. Most of them are turned away, hopefully -- or most, if not all of them, are turned away.

Also with 35,000 preparers, we are going to have some people that are perpetrators of fraud, that we catch and turn in to the IRS and stop. But when we stop them, each of those things reduces the number of returns.

In that process, we get some press, occasionally, bad press that impacts various markets where less customers come to us because of that publicity. So that combined impact of those three, the resulting impact we believe is from low to mid single-digit decrease.

Alex Paris - *Barrington Research Associates, Inc. - Analyst*

With that said, that doesn't mean you're going to have a decline. That means you might be having less of an increase because of those issues.

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Exactly.

Alex Paris - *Barrington Research Associates, Inc. - Analyst*

Yes, okay. All right; I think I understand that. With that said, as you pointed out, the IRS said through the early part of the tax season the number of returns were down 3.6%. You were much more in line with that than your competitor that reported last night.

So I don't see any big decline versus the average experience for Liberty Tax, say, compared to your competitor that announced yesterday. So we haven't seen that. But maybe we have seen that impact; you just would've been up. You would've been down less or up more; is that how you'd think about it?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Yes, and even more because the fraudulent returns tend to be the early filing customers with earned income credit. They all typically file by February 10 or 15, or the vast majority of them. So most of the fraud is early-season versus late-season.



Alex Paris - *Barrington Research Associates, Inc. - Analyst*

So perhaps we've seen most of the impact on your filing associated -- the filing impact from fraud already. And now we should see -- that's not to say that there's not going to be fraud committed between now and the end of the year by unscrupulous people. But is it reasonable to assume that you've absorbed most of that impact already?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Except for any negative publicity, yes.

Alex Paris - *Barrington Research Associates, Inc. - Analyst*

Yes, yes. Okay. Then in the previous -- I think Lee asked the question. It is your expectation -- you're not making a projection -- but because you have historically outperformed, that's your goal at least: to outperform the assisted category again this year.

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

You can safely say that's our goal.

Alex Paris - *Barrington Research Associates, Inc. - Analyst*

Okay. Then how do you feel about the proportion, the old 60/40 assisted versus do-it-yourself, which was I think 59/41 last year? What's your feeling for that this year?

Are there any -- I guess ACA should increase the likelihood that people go to assisted. But what would your expert opinion be? Would you expect that to be sustained, no change one way or another?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Yes, if you look at the numbers, the last few years before this year about this time the do-it-yourself was up over 7% and this year it's up less than 4%. So that certainly lends to our belief that it's going to stay approximately the same, if not move in the direction of assisted.

Alex Paris - *Barrington Research Associates, Inc. - Analyst*

Okay. Then in terms of the impact of ACA so far this tax season, you, like your competitor last night, seem to be saying that the ACA filers will be a later tax season impact.

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Yes, I think I said in my comments that we expect all of the impact of ACA to be from now until April 18. I guess I should add here that there's four more days in this filing period that we didn't talk about. There's an extra day because of Leap Year, and because April 15 is a Friday and a holiday there are going to be three extra days in the season, at the end of the season, from April 15 to 18.

So the season is actually four days longer this year than last year, which should again make a movement towards later-season filings.



Alex Paris - *Barrington Research Associates, Inc. - Analyst*

Okay; thank you for all that. A question on the stores. You're up about just shy of 200 on permanent stores, down about 51 on seasonal stores. Just to make sure that I understand the language, seasonal means kiosk?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Yes, those typically are seasonal kiosks in a Walmart or a Kmart or a Sears or Dollar General.

Alex Paris - *Barrington Research Associates, Inc. - Analyst*

Okay. And those stores typically generate significantly fewer returns than a permanent store; is that correct?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Exactly.

Alex Paris - *Barrington Research Associates, Inc. - Analyst*

Yes, okay. Then with regard to Siempre, I suspect a majority of your nearly 200 permanent stores are Siempre this year, correct?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Yes. Just more than half are -- or approximately half of the storefronts are Siempre.

Alex Paris - *Barrington Research Associates, Inc. - Analyst*

Okay. Then -- so that gives you -- what's your total number for Siempre then? I think you had 57 or so last year.

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

144.

Alex Paris - *Barrington Research Associates, Inc. - Analyst*

144, great. Then you mentioned that you are already starting to sell new stores to existing franchises already this year for next tax season. Is that intentional? Is that an earlier start to that process than previous years?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

We did start, yes, earlier in terms of the number, the quantity of presentations, yes, this year.



Alex Paris - *Barrington Research Associates, Inc. - Analyst*

All right. Just in summary, though, going back to the big picture, there's no reason to think that there won't be 2 million more filers at the IRS this year than last year due to increased employment, that sort of thing. The fact that we got off to an early -- we got off to a slow start in the early tax season really has no impact, nor should it, on the full tax season. People still got to file their taxes.

That suggests that the second half of the tax season will be stronger than the first half. Right?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Yes. That trend, Alex, is a multiyear trend and it's been happening for about five or six years.

Alex Paris - *Barrington Research Associates, Inc. - Analyst*

Yes, for sure. You know what? I guess I'll just leave it at that.

So you're perhaps a little bit short of your store target, but a lot better than last year; and the best is ahead of us in this second half of the tax season in terms of units. You're getting better pricing.

Are you getting better pricing just overall, right? Not just on financial products?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Exactly. Our average net fee is up 4.7%.

Alex Paris - *Barrington Research Associates, Inc. - Analyst*

Great. Okay; well, that's good. Sorry for hogging so much time. Appreciate your additional color.

Operator

Michael Millman, Millman Research.

Michael Millman - *Millman Research Associates - Analyst*

You and Block seem to be saying some of the same things, although -- surprisingly -- neither one of you has done as well as the market. And particularly when you look at the market numbers or the IRS numbers, it looks like once the refund cash was put out in the market we've seen weekly increases in the IRS numbers, yet you and Block don't seem to reflect those.

I was wondering if you could discuss that or maybe say it differently than you've already --

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

I think if I read between the lines of what Block said -- and I agree with it, certainly substantially -- that when people come into our offices and are trying to commit fraud, and the national companies are much more diligent on stopping fraud, they go somewhere else to do their tax return. The mom-and-pops or some of the mom-and-pops may be less diligent on policing fraud, and therefore the mom-and-pops get to win temporarily on those customers.

Michael Millman - *Millman Research Associates - Analyst*

But you had indicated that most of this is done earlier than later. Yet when we can we look at the weekly numbers increasing versus your numbers flat compared with the end of the quarter. Their numbers didn't seem to really do much during the month.

I'd say also I'm not sure what effect it is -- you're reporting date-to-date. I don't know if -- or maybe I should ask: How much impact does that have on the numbers?

But mostly it's the weekly trends for the IRS seem to differ from your and Block's weekly numbers.

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Well, they're not too much different. The day-to-day versus the date-to-date is less than a 1% impact. If someone comes in to file a return and they're sent away, then they're obviously delayed filing somewhat.

Michael Millman - *Millman Research Associates - Analyst*

Block also mentioned that they were being affected, maybe hurt, by RALs. Maybe you can talk about those as well in terms of what benefit they are giving you versus what those who don't have them are missing out.

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Yes, let me give a little more color on that. We're not going to give exact numbers, because it's competitive information.

But I will say that the new refund loan that we have, the Refund Advance loan -- happens to be the same acronym as RAL -- is not nearly the same as a RAL. But it was less than 10% of our customers. It was a competitive advantage in the marketplace, certainly over Block and many of the mom-and-pops who didn't have it.

And that would be -- that's been a positive mid-digit, single-digit increase in our returns through the end of February. That expired on February 29 and it won't be impacting the latter half of the season.

Michael Millman - *Millman Research Associates - Analyst*

Okay. Thanks, John.

Operator

Lee Jagoda, CJS Securities.

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Welcome back.

Lee Jagoda - *CJS Securities - Analyst*

Thank you. One more question on Siempre. Can you give us a sense for the performance of the year-one Siempre stores this year versus the first-year Liberty locations in terms of both return volume and average fee at those locations?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Again, that's competitive information so I'm not going to give you exact numbers. But we're happy with the numbers; they met our projections. And they are in line with first-year Liberty locations.

Lee Jagoda - *CJS Securities - Analyst*

Is there any difference in the attachment rate for financial products between Siempre and Liberty?

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

It's about the same.

Lee Jagoda - *CJS Securities - Analyst*

Okay. Thanks very much.

Operator

There are no further questions at this time. I would now like to turn the call back over to John Hewitt for closing remarks.

John Hewitt - *Liberty Tax, Inc. - Chairman, President, CEO*

Well, thank you, everyone, for your interest. Again, our goal is to have happy, successful employees and happy, successful franchisees. Thank you and have a great day.

Operator

This concludes today's conference call. You may now disconnect.

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